No. 17,313

IN THE

United States Court of Appeals
For the Ninth Circuit

FRANCIS L. ROONEY and IRENE ROONEY,
Appellants,

v.

UNITED STATES OF AMERICA,
Appellee.

On Appeal from the Judgment of the United States District Court for the Northern District of California

BRIEF FOR THE APPELLEE

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BRIEF FOR THE APPELLEE

OPINION BELOW

The District Court's memorandum opinion and order (R. 20-24) is reported at 189 F. Supp. 733. The court's findings of fact and conclusions of law (R. 24-30) are not officially reported.

JURISDICTION

This appeal involves federal income taxes. The taxes in dispute, amounting to $22,553.02, were paid on November 20, 1956. (R. 4, 18, 25.) Claims for refund (R. 6-15) were filed on January 28, 1957 (R. 26) and were rejected on June 9, 1958 (R. 27). Within the time provided in Section 3772 of the Internal Revenue Code

of 1939 and Section 6532 of the Internal Revenue Code of 1954, and on October 17, 1958, the taxpayers brought an action in the District Court for recovery of the taxes paid. (R. 3-17.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. The judgment was entered on November 14, 1960. (R. 31.) Within 60 days and on January 6, 1961, notice of appeal was filed. (R. 32.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the taxpayers carried their burden of showing their correct tax liability.

2. Whether the District Court was correct in holding that the Commissioner's allocation of expenses between taxpayers and their wholly-owned corporation was necessary to reflect income clearly and was proper under Section 482 of the 1954 Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations may be found in the Appendix, *infra*.

STATEMENT

The facts as found by the District Court (R. 24-29) may be summarized as follows:

The taxpayers, Francis and Irene Rooney, are husband and wife, residing in Sacramento County, California. They are hop farmers. During 1952 and 1953

they raised profitable crops of hops. In 1954 they also raised a profitable crop. The taxpayers transferred their 1954 crops together with other farm assets, to their wholly-owned corporation known as F. L. Rooney, Inc. This transfer was made as of July 31, 1954, and the crop was sold in exchange for all of the stock of that corporation. Prior to the transfer the taxpayers had incurred expenses in raising the crop and they deducted these expenses on their 1954 return. (R. 25, 27-28.)

Since the taxpayers reported no income from the transfer of the crop and other farm assets to their wholly-owned corporation but did report the expenses, they showed a net operating loss for 1954 on their individual tax return. The 1954 crop was harvested between mid-August and the first of September, 1954, and their corporation reported all of the income from its sale without any of the expenses of raising it. (R. 25, 28.)

The taxpayers' net operating loss for 1954 gave rise to their present claim for refund and this suit. They also attempted to carry the net operating loss back to the years 1952 and 1953. The District Director of Internal Revenue, in order to reflect clearly the income of taxpayers and their corporation, made certain allocations of expenses between the taxpayers and their corporation, which eliminated the net operating loss for 1954 and its carryback to 1952 and 1953.[1] (R. 21-22, 28.)

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[1]Of course, the same allocation had the effect of reducing the corporate income for the year beginning August 1, 1954, and consequently its tax liability.

The taxpayers below attacked those allocations. The Court found, *inter alia,* that the taxpayers did not carry their burden of showing that they had overpaid their income taxes for the years in question and sustained the District Director's allocations as a proper and reasonable exercise of the discretion granted under Section 482 of the 1954 Internal Revenue Code because they were necessary to reflect income clearly between the taxpayers and their controlled corporation. (R. 20-24, 28-29.)

SUMMARY OF ARGUMENT

1. A tax refund suit involves a redetermination of a taxpayer's entire tax liability. Taxpayers must not only show that the Commissioner's assessment was wrong and that they do not owe the tax they seek to recover, but they must establish the facts from which their correct liability can be determined.

The taxpayers at bar have wholly failed to carry this burden of proof, for they introduced no evidence from which a correct determination of their liability could be computed. Since taxpayers had the opportunity below to prove their case, the United States should not be subjected to further proceedings because they failed to do so. The District Court properly dismissed taxpayers' complaint and the dismissal should be sustained.

2. Under 1954 Code Section 482, the Commissioner is authorized to allocate gross income, deductions, and other amounts between two or more taxpayers con-

trolled by the same interests if he determines that the allocation is necessary to prevent evasion of taxes or to reflect clearly the income of the taxpayers.

Subsequent to incurring expenses in growing their 1954 hop crop (deductible under their usual method of accounting) but before they harvested the crop, taxpayers transferred the crop and other farm assets to their newly-formed corporation solely in exchange for all of its stock. The income from the crop was reported by the corporation, and taxpayers, as a result of the expenses, reported a loss for 1954 which they attempted to set off against the income from their profitable 1952 and 1953 crops.

Under Section 482, the Commissioner allocated the deductions to taxpayers' controlled corporation, eliminating the distortion of income resulting from the reporting of a loss on a crop which they admitted was in fact profitable. The severance of their taxable year by incorporating their business when, due to the seasonal nature of the business, taxpayers had incurred expenses but had not yet received the resulting income prevented taxpayers' method of accounting from clearly reflecting income. The allocation effected a clear reflection of income by matching the expenses against the resulting revenue from the crop and prevented taxpayers from deducting and carrying back to prior years a purported loss for a year which was in fact profitable.

The issue involved here is identical to that presented in *Central Sugar Co. v. Commissioner*, 198 F. 2d 214, decided by the Court of Appeals for the Second Cir-

cuit. That case is indistinguishable from the one at bar, was correctly decided, and therefore should be followed. Other decisions, both of this Court and other Courts of Appeals, present analogous situations where the Commissioner's exercise of his authority under Section 482 in order to reflect income clearly was sustained. Those cases also involved the severance of the annual accounting period by some fundamental change in taxpayers' circumstances thus preventing a matching of expenses with the resulting income and causing a consequent distortion of income.

Moreover, Section 482 invests the Commissioner with special discretion with respect to the correct reflection of income, in addition to the presumptive correctness always attending his deficiency determination. To overturn the determination of whether income is clearly reflected, taxpayers must show that that determination is arbitrary and unreasonable. Taxpayers have not carried this burden.

ARGUMENT

I

THE TAXPAYERS DID NOT CARRY THEIR BURDEN OF SHOWING THEIR CORRECT TAX LIABILITY

This appeal arises from a suit against the United States for refund of income taxes.

A suit to recover a tax erroneously paid, although an action at law, is equitable in its function and is the lineal successor of the common law action of assumpsit for money had and received. The statutes authorizing

tax refunds and suits for their recovery are predicated upon the same equitable principles that underlie an action in assumpsit, and taxpayers' recovery of taxes is by virtue of a right measured by equitable standards. *Stone v. White,* 301 U.S. 532; *Champ Spring Co. v. United States,* 47 F. 2d 1 (C.A. 8th).

A suit for refund of overpaid taxes involves a redetermination of taxpayers' entire tax liability. *Lewis v. Reynolds,* 284 U.S. 281. The taxpayers must not only show that they do not owe the money they seek to recover, but they must establish the essential facts from which a correct determination of their liability can be made. *Helvering v. Taylor,* 293 U.S. 507; *Roybark v. United States,* 218 F. 2d 164 (C.A. 9th); *Maroosis v. Smyth,* 187 F. 2d 228 (C.A. 9th); *Decker v. Korth,* 219 F. 2d 732, 737 (C.A. 10th), certiorari denied, 350 U.S. 830; *United States v. Harris,* 216 F. 2d 690 (C.A. 5th); *United States v. Pfister,* 205 F. 2d 538, 541-542 (C.A. 8th).

In *Roybark* this Court upheld the dismissal of taxpayers' suit for refund of taxes where taxpayers offered no proof of the amount of their income and the cost of sales for the years in question, although the taxes were assessed and paid on a discarded theory of what was taxable income.

The case at bar, we submit, is virtually on all fours with *Roybark.* The taxpayers here, as the District Court found (R. 25-26), have not shown the amounts of their income and deductions for the years in question. Nor have they shown the total amount of taxes paid, assuming that sums in addition to the claimed

amount of $22,553.02 were paid for the years 1952-1954. Taxpayers did not introduce into evidence their income tax returns, their books of account, or the tax returns of their corporation, nor did they otherwise offer any evidence with respect to these crucial amounts. They also did not offer the Commissioner's notices of deficiency showing the reasons for the proposed deficiency assessments. On the basis of the record it is consequently impossible to make a correct determination of the amount of their tax liability, much less to determine the amount of the overpayment, and taxpayers therefore have failed to carry their burden of proof.

It is insufficient to point, as taxpayers do (Br. 27-28), to the fact that payment of $22,553.02 was made, for this does not establish the amounts of their income, deductions, and tax due, and without those amounts the amount of their tax liability is not known and no judgment for refund of overpaid taxes could have been awarded them even if they had prevailed on the merits of the assessments.[2] It is unnecessary to belabor the point that taxpayers had the opportunity below to prove the facts on which their recovery would be predicated had they prevailed, and that the United States, as any defendant, should not be subjected to further legal proceedings because taxpayer-plaintiffs either through inadvertence or design did not prove (or attempt to prove) those facts. We submit that the District Court was warranted in holding

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[2]The payment of $22,553.02 merely established the amount of the deficiencies assessed against taxpayers, and nothing more.

(R. 30) that taxpayers failed to carry their burden of proof and that it properly dismissed taxpayers' complaint.

II

THE ALLOCATION OF EXPENSES TO TAXPAYERS' WHOLLY-OWNED CORPORATION WAS NECESSARY TO REFLECT INCOME CLEARLY AND WAS PROPER UNDER 1954 CODE SECTION 482

Subsequent to incurring substantial expenses in growing their 1954 hop crop and shortly before the crop was harvested, the taxpayers transferred the crop and other farm assets to their newly-organized corporation solely in exchange for all of the corporation's stock. Until the transfer, which was effected as of July 31, 1954, the corporation had had no assets; the transferred assets, consisting mostly of the unharvested crop, were appraised at about $196,000 shortly before the corporation was organized. (R. 66.)

Taxpayers had entered into a contract for sale of the crop with S. S. Steiner, Inc., on January 22, 1954 (R. 58), and the income from the sale was reported by the corporation (R. 28). Since taxpayers apparently had little income for 1954, once their crop income was diverted to their corporation (R. 80), the expenses of raising the crop gave them, for tax purposes, a substantial loss for 1954 which they attempted to carry back and set off against their income from their profitable 1952 and 1953 crops (R. 27-28).

The Commissioner (through the District Director) allocated, under 1954 Code Section 482 (Appendix,

infra), the expenses deducted by taxpayers to their corporation.[3] As the District Court stated (R. 28), it is apparent that the allocation was made to reflect income clearly by matching income from the sale of the crops with the related expenses and thus avoid the artificial loss reported by taxpayers through the arbitrary severance of their annual accounting period.

Section 482 empowers the Secretary or his delegate to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between "two or more organizations, trades, or businesses (whether or not incorporated * * *) owned or controlled directly or indirectly by the same interests, * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses."

Section 39.45-1(a) of Treasury Regulations 118 (Appendix, *infra*), promulgated under 1939 Code Section 45, which corresponds to Section 482, defines "controlled taxpayer" as any one of two organizations (including a partnership or sole proprietorship) owned by the same interests. It also defines "true net income", in the case of a controlled taxpayer, as the net income which would have resulted to the controlled taxpayer had it dealt with the other members of the

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[3]The District Court found that taxpayers did not establish what the allocation was which they were attacking. (R. 28.) The failure to show the items and amounts allocated is part of the taxpayers' over-all failure to establish the correct amount of tax due and the amount of the overpayment. See Argument Point I, *supra*. Since the District Court assumes in its opinion (R. 20-24) that expenses were allocated, we shall make the same assumption.

group at arm's length. Subsection (b) provides that the purpose of the statute is to place a controlled taxpayer on tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of the controlled taxpayer. Subsection (c) provides, in part, that transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. It also provides that the authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Allocations to reflect clearly the income of a controlled taxpayer are thus authorized by the section which is not restricted to transactions that are motivated by tax avoidance considerations. *Dillard-Waltermire, Inc. v. Campbell,* 255 F. 2d 433 (C.A. 5th); *Central Cuba Sugar Co. v. Commissioner,* 198 F. 2d 214 (C.A. 2d), certiorari denied, 344 U.S. 874; *National Securities Corp. v. Commissioner,* 137 F. 2d 600 (C.A. 3d), certiorari denied, 320 U.S. 794; *Asiatic Petroleum Co. v. Commissioner,* 79 F. 2d 234 (C.A. 2d), certiorari denied, 296 U. S. 645.

Due to the fact that taxpayer's business was seasonal, the bulk of the year's expenses was incurred

during the beginning of the taxable year, while the resulting income was realized during the latter part of the year. By incorporating their business shortly prior to harvesting the crop, taxpayers severed the taxable year on the basis of which they had reported their farm business income. The distortion of income resulting from this severance is manifest when it is recognized that the taxpayers are seeking to deduct and carry back to prior years a loss from conducting a business for a portion of the year when, in fact, the business for the whole year was conducted at a profit.[4] Section 482, quite plainly, is designed to prevent such a distortion, and an allocation is, on the very face of things, necessary to reflect income clearly and properly.

As stated above, Section 39.45-1(b) of Treasury Regulations 118 (Appendix, *infra*) provides that the purpose of such a provision is to place commonly controlled taxpayers on a tax parity with uncontrolled taxpayers. A brief comparison of the effect of taxpayers' transfer of the crop to their wholly-owned corporation with that of an arm's length transaction demonstrates the necessity for the Commissioner's allocation. If taxpayers had sold their crop and other farms assets in an arm's length transaction, they would, at a minimum, have recovered the expenses as part of the purchase price, and hence would not have reported a loss for 1954. However, because the exchange of the crop and other

[4]Mr. Rooney testified (R. 65) that the 1954 crop was profitable; that is, the income realized from its sale exceeded his and the corporation's expenses.

assets for the stock of their corporation qualified under 1954 Code Section 351 (Appendix, *infra*), they reported no income on the exchange, but deducted the expenses incurred in raising the crop. The interruption of their normal accounting period by the transfer of the crop and other farm assets after the expenses had been incurred, but before the resulting income had been garnered, clearly placed taxpayers on a different footing for tax purposes than if they had dealt at arm's length with someone other than their wholly-owned corporation, and evinces the distortion of income resulting from the transfer to their corporation of the crop at that particular time of taxpayers' year.[5]

In *Central Cuba Sugar Co. v. Commissioner,* 198 F. 2d 214, certiorari denied, 344 U.S. 874, the Second Circuit decided the identical issue involved here. There the taxpayer-corporation incurred substantial expenses in raising a crop of sugar and, prior to the time that the crop was to be harvested, it transferred the crop and its business to a new corporation in a tax-free exchange for the new corporation's stock. As

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[5]If the transfer had occurred after taxpayers harvested the crop, they would have reported the income therefrom. Taxpayers' argument (Br. 11) that in an arm's length transaction the sale of the land and other assets would result in capital gains treatment is beside the point, for even in that event the expenses would be taken into account in computing gain. Moreover, it is at least doubtful whether taxpayers' argument rests upon a sound premise, for Section 1231(b)(4) of the 1954 Code authorizes capital gains treatment on the sale of an unharvested crop only when sold with the land; here there was no sale of the land (R. 63-64), since taxpayers only had a leasehold interest therein, which is not sufficient under the statute. Treasury Regulations (1954 Code) Section 1.1231-1(f).

in the case at bar, the new corporation reported all of the income from the sale of the crop, and the taxpayer attempted to carry back the loss resulting from deduction of the expenses to earlier taxable years. The Court of Appeals sustained the Commissioner's allocation of the expenses to the new corporation under 1939 Code Section 45, holding that the allocation was necessary to reflect income clearly. The court noted that an allocation under Section 45, which had its genesis in the consolidated return provisions, would dispel the fiction that a loss was sustained in the same manner that a consolidation would.

The court went on to state that (p. 216):

> The present statute was designed to deny the power to shift income or deductions arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns. U. S. Treas. Reg. 111, §29.45-1(b). In the case at bar, had the taxpayer sold its assets, including a crop of sugar about to be harvested, in an arm's-length transaction, the temporarily invested expenses would have been recouped as part of the purchase price. See U. S. Treas. Reg. 111, §29.45-1(a)(6). But in a sale for stock between related corporations, no such income is recorded and the accounts of the transferor cannot properly reflect the true income status of the enterprise as a going concern. Hence, to achieve "the rough matching of expenses and income previously attained," *United States v. Lynch*, 9 Cir., 192 F. 2d 718, 721, allocation of the expenses to the concern which is to profit by them is the only alternative.

Central Cuba Sugar, we submit, is on all fours with the instant case and should be followed. That it was correctly decided is not contested by taxpayers. They argue, however (Br. 8-11), that a division of a taxable year such as they effected with their controlled corporation should be permitted because it does not exempt income from tax but only postpones the tax. On this ground they attempt to distinguish *Central Cuba* (Br. 17-18), arguing that the deferral of tax there was subject to Section 45 because it would have resulted in the complete avoidance of tax, the successor taxpayer being a foreign corporation. The fallacy in taxpayers' argument is that the issue in *Central Cuba,* like that here, was whether there was a distortion of income, not whether income would permanently or temporarily escape tax.[6] The court's opinion deals solely with the question of whether income was clearly reflected, and does not even implicity make the fallacious assumption, as taxpayers do, that transactions which effect a postponement of tax are not subject to the reach of Section 482 regardless of whether income is clearly reflected.

Moreover, taxpayers' argument does violence to the basic concept of annual accounting periods, for by contending that allocation is not justified, though income is distorted in a particular year, where the lapse of an indefinite period of years may eliminate

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[6]Nor does the statute discriminate between foreign and domestic corporations, allowing allocation in the case of the former, but not the latter.

the distortion, taxpayers ignore the fundamental principle that we are on an annual accounting period basis. Thus, it is no answer to state, as taxpayers do (Br. 9), that at some unspecified future time, which is the last year of the corporation's operations, the distortion of income presently being produced will be eliminated.

United States v. Lynch, 192 F. 2d 718 (C.A. 9th), cited by the court in *Central Cuba Sugar,* involved an analogous situation where the termination of the period in which income was normally earned also distorted income. There a corporation deducted during the course of its taxable year warehousing expenses and, like the taxpayers here, reported storage income only when goods were removed from storage and income was received, usually near the end of its taxable year. The corporation was liquidated shortly before the end of its taxable year—before it had received the storage income but after it had accrued the warehousing expenses. Under 1939 Code Section 41, which is similar to Section 482 to the extent that it empowers the Commissioner to require a method of accounting which will clearly reflect income, the Commissioner held that the storage charges should be accrued to the date of liquidation and reported as income. This Court sustained that determination and held (p. 721):

> Acceptance of the corporation's accounting method in prior years did not prevent the Commissioner from later exercising his statutory power within proper limits. The fundamental change in the corporation's circumstances, that

> is, its liquidation and consequent non-existence, prevented its accounting technique from achieving the rough matching of expenses and income previously attained.

Similarly, in the case at bar, the transfer of taxpayers' crop and farm assets and the resulting division of their annual accounting period was a fundamental change in their circumstances necessitating a departure from taxpayers' usual method of accounting and the exercise of the Commissioner's statutory power in making the allocation to match income and expenses.

In *Dillard-Waltermire, Inc. v. Campbell*, 255 F. 2d 433 (C.A. 5th), the taxpayer-corporation sold oil drilling rigs for their book value and certain uncompleted drilling contracts at cost to a partnership consisting of the taxpayer's stockholders. The taxpayer, on the completed contract method of accounting, reported no income from the contracts which were more than half completed. *Dillard-Waltermire* is similar to the case at bar in that the sale of the contracts and assets of the corporate taxpayer took place prior to the time that its prior efforts could result in the fruition of income under its regular method of accounting. There, under Section 45, the correct reflection of income was achieved by allocating to the taxpayer a portion of the income actually realized by the successor partnership. Here the Commissioner did not go so far as to allocate income to the taxpayers, but rather determined that their expenses should be allocated to their controlled corporation—those expenses having bene-

fited the corporation by enabling it to realize income which they would have realized had they not transferred their business at this particular time of the year. See also *Standard Paving Co. v. Commissioner,* 190 F. 2d 330 (C.A. 10th), and *Jud Plumbing & Heating Co. v. Commissioner,* 153 F. 2d 681 (C.A. 5th).

In addition to the presumptive correctness which always attends the Commissioner's deficiency determination, his determination concerning the correct reflection of income under Section 482 represents the exercise of a special discretion vested in him by Congress. To overturn his determination of what is a clear reflection of income, the taxpayer must affirmatively demonstrate that that discretion had been abused—that the determination is arbitrary and unreasonable. *Aiken Drive-In Theatre Corp. v. United States,* 281 F. 2d 7 (C.A. 4th); *G. U. R. Co. v. Commissioner,* 117 F. 2d 187, 189; *National Securities Corp. v. Commissioner, supra.* As we have pointed out above, the Commissioner's determination that income was not clearly reflected is amply supported by taxpayers' reporting a loss on a profitable crop and by the decision in *Central Cuba Sugar Co. v. Commissioner, supra.* Taxpayers have not shown that the Commissioner abused his discretion and, in fact, they do not contest the fact that there was a distortion of income. Rather, they argue (Br. 8-12) that the Commissioner's allocation also does not clearly reflect income because the allocation gives their corporation two years' deductions in one year. Even if it is as-

sumed that the allocation does produce this result,[7] taxpayers have not established that the Commissioner's allocation was arbitrary. Although the allocation may not effect a theoretically perfect reflection of income, taxpayers, to upset that allocation, must show that income is more clearly reflected without the allocation than with it; and they have not done so. Furthermore, taxpayers can hardly complain of an allocation which, in giving their controlled corporation two years' deductions in one year, is beneficial to that corporation.

Section 482 applies to any commonly controlled organizations, whether or not incorporated, and thus is as applicable to individual taxpayers and their wholly-owned corporation as it was to the two related corporations in *Central Cuba Sugar*. See Section 39.45(a)-1(a) of Treasury Regulations 118. The taxpayers here, however, argue (Br. 25-27) that since "It is required that the control exist during the entire period in which the allocated item accrues", the control required by Section 482 is missing—their corporation having become a viable entity only as of July 31, 1954. Taxpayers did not raise and rely on this issue below and hence are not entitled to raise it on appeal. Nevertheless their argument, for which they cite no authority, is without merit.

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[7]The only evidence introduced with respect to the corporation's accounting method and period was that it was on a July 31 fiscal year. (R. 61.) Its tax returns were not introduced; neither was any other evidence offered to establish its method of accounting, whether the Commissioner had made any adjustments in its method or period of reporting income, or of the effect of the allocation on its taxable income. Taxpayers' conclusion is therefore not supported by the record.

Taxpayers' unsupported premise completely misinterprets the reach and purpose of the statute. Control or ownership must exist when the taxpayers deal with each other. As the legislative history indicates, the predecessor of Section 482 was designed to prevent the avoidance of tax or the distortion of income by the shifting of profits from one business to another. H. Rep. No. 2, 70th Cong., 1st Sess., p. 146 (1939-1 Cum. Bull. (Part 2) 384, 395); S. Rep. No. 960, 70th Cong., 1st Sess., p. 24 (1939-1 Cum. Bull. (Part 2) 409, 426). See *Asiatic Petroleum Co. v. Commissioner, supra,* pp. 236-237. This purpose is effected if the taxpayers are commonly controlled when they deal with each other; control at another time is unimportant. Section 39.45-1(c) of Treasury Regulations 118 (Appendix, *infra*) supports this view in stating that *transactions* between controlled taxpayers will be subject to special scrutiny. Taxpayers' interpretation of "control" emasculates Section 482, for any transaction with a newly formed taxpayer would avoid its application; it is difficult to believe that a statute so broadly framed as Section 482 was intended to be so easily circumvented. Taxpayers owned and controlled the corporation from the first moment of its existence (R. 86-88) and they cannot avoid the Section's application by arguing lack of control at an irrelevant point of time.

Taxpayers contend (Br. 11-14) that the allocation does not put them in the same position that they would have been in had they been dealing at arm's length. It is somewhat difficult to understand this

argument, for as taxpayers point out (Br. 11), in dealing at arm's length they would not have been able to claim the deductions here at issue—which is the very result sought to be achieved by the allocation—and would not have reported an artificial loss on the profitable 1954 crop.

To support this argument, taxpayers rely (Br. 12) on *Simon J. Murphy Co. v. Commissioner,* 231 F. 2d 639 (C.A. 6th). The court in *Murphy* distinguished that case from the situation involved in *Central Cuba Sugar* (and also in this case). In any event, the Fifth Circuit in *Tennessee Life Insurance Co. v. Phinney,* 280 F. 2d 38, reached an opposite result with respect to the same issue involved in *Murphy*, and we agree with the Fifth Circuit's view that *Murphy* was incorrectly decided due to the Sixth Circuit's failure to uphold the Commissioner's determination that an allocation under Section 45 was necessary to reflect income clearly where altered circumstances (a corporate dissolution) caused a distortion of income under the taxpayer's usual accounting method.[8]

Taxpayers urge (Br. 21-25) that allocating the expenses has the practical result of requiring them to inventory unharvested crops, which is not a permissible method of accounting; they claim that this demonstrates that the allocation is improper and arbitrary. Without reaching the question of whether they are in effect inventorying such crops, it is settled law that

[8] *Diamond A. Cattle Co. v. Commissioner,* 233 F. 2d 739 (C.A. 10th), also cited by taxpayers (Br. 15-16), does not involve an application of the Commissioner's special discretion under Section 482 or Section 45 and hence is inapposite.

the application of Section 482 is not barred because it conflicts with other provisions of the Code. As the Court of Appeals for the Third Circuit aptly said in *National Securities Corp. v. Commissioner,* 137 F. 2d 600, 602:

> Section 45 [now section 482] is directed to the correction of particular situations in which the strict application of the other provisions of the act will result in a distortion of the income of affiliated organizations. In every case in which the section is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so Section 45 would be wholly superfluous. We accordingly conclude that the application of Section 45 may not be denied because it appears to run afoul of the literal provisions * * * [of the Internal Revenue Code] if the Commissioner's action in allocating under the provisions of Section 45 the loss involved in this case was a proper exercise of the discretion conferred upon him by the section.

See *Aiken Drive-In Theatre Corp. v. United States,* 281 F. 2d 7 (C.A. 4th); *Advance Machinery Exch. v. Commissioner,* 196 F. 2d 1006, 1009 (C.A. 2d). And their argument (Br. 12) that the application of Section 482 denies them the right to avail themselves of the loss carry-back provisions of the Code neglects the central issue here—whether claiming a loss of 1954 clearly reflects income.

In sum, the allocation was necessary to reflect income clearly, and was within the Commissioner's discretion under Section 482; moreover, the taxpayers

have not shown it to be arbitrary and unreasonable, nor have they shown why *Central Cuba Sugar Co. v. Commissioner, supra,* should not be followed.

CONCLUSION

For the reasons stated above, the judgment of the District Court is correct and should be affirmed.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code of 1954:

Sec. 351. Transfer to Corporation Controlled by Transferor.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

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(26 U.S.C. 1958 ed., Sec. 351.)

Sec. 482. Allocation of Income and Deductions Among Taxpayers.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

(26 U.S.C. 1958 ed., Sec. 482.)

Treasury Regulations 118 (1939 Code):

Sec. 39.45-1 *Determination of the taxable net income of a controlled taxpayer*—(a) *Definitions.* When used in this section:

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations in this part), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) the purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income,

deductions, credits, or allowances, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * * * *

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.